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BEFORE THE ARIZONA CORPORATION CC



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2009 DEC 11 A 10:49

AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF
FARMERS WATER CO., AN ARIZONA
CORPORATION, FOR A DETERMINATION
OF THE CURRENT FAIR VALUE OF ITS
UTILITY PLANT AND PROPERTY AND FOR
INCREASES IN ITS RATES AND CHARGES
FOR UTILITY SERVICE.

DOCKET NO. W-01654A-08-0502

STAFF'S OPENING BRIEF

The Arizona Corporation Commission ("Commission") Utilities Division Staff ("Staff") hereby submits this closing brief in support of Staff's recommendations made in pre-filed testimony and oral testimony in this Farmers Water Company ("Farmers Water" or "Company") rate application. As explained in Charles Myhlhousen's direct pre-filed testimony:

Farmers is an Arizona-based corporation that provides water utility service to portions of Pima County. The Company serviced approximately 2,240 customers during the test year ended September 30, 2007. The Company's current rates were approved in Decision No. 63749, dated June 6, 2001, and became effective in July 1, 2001. The Company is located in the Tucson Active Management Area. The Company provides water utility service through four water systems: the Sahuarita, Continental, Santa Rita Springs and Sahuarita Highlands systems. The Company is an Arizona Sub-Chapter "S" Corporation since October 1, 2005.¹

In Decision 68920 the Company was granted an extension of its Certificate of Convenience and Necessity ("CC&N") and was also ordered to file a rate case by June 30, 2008, using a 2007 test year.² After receiving a ninety (90) day extension, the Company filed this rate case on September 29, 2008.³

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¹ Ex. S-3 at 3:1-10.

² Ex. S-3 at 3:14-16.

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1 Staff recommends rates that would produce operating revenue of \$710,333 and operating
2 income of \$71,050 for a 10.00 percent operating margin.⁴ This would increase annual operating
3 revenue by \$147,050 or 26.11 percent over test year revenues of \$563,283.⁵ Staff recommends a
4 monthly minimum charge of \$8.25 and \$9.28 for 5/8 and 3/4 inch residential meters respectively,
5 with an inverted three tier commodity rate of \$1.35 (for 1-4,000 gallons), \$1.90 (for 4,001-10,000
6 gallons), and \$2.95 (for all gallons over 10,000) per thousand gallons.⁶ Although the Company and
7 Staff are largely in agreement on most issues,⁷ the remaining disputed issues to be discussed herein
8 relate to Staff's recommendation that individual shareholder income tax expenses be excluded from
9 the revenue requirement, that the six percent interest rate requirement for customer deposits be
10 maintained, and that standpipe users pay no monthly minimum charge.⁸ Due to the complexity and
11 importance of the income tax expense issue, the parties requested and were ordered to file closing
12 briefs discussing the remaining disputed issues in this matter.⁹

13 **I. INDIVIDUAL SHAREHOLDER INCOME TAX EXPENSES SHOULD BE**
14 **EXCLUDED FROM THE COMPANY'S REVENUE REQUIREMENT IN THIS**
15 **CASE.**

16 Farmers Water is wholly owned by Farmers Investment Company ("Farmers Investment")
17 and the two companies file consolidated tax returns.¹⁰ Farmers Investment is also a Sub-Chapter "S"
18 Corporation and has thirty-five (35) shareholders.¹¹ In addition to owning Farmers Water, Farmers
19 Investment has separate divisions dedicated to business endeavors separate from water utility
20 service.¹² Farmers Water submitted a shareholders agreement between Farmers Investment and it's
21 shareholders which states, "This Shareholders Agreement ("Agreement") is entered into effective as
22 of September 30, 2005, by and among Farmers Investment Co., an Arizona corporation ("the
23

24 ³ Ex. S-3 at 3:16-18.

25 ⁴ Ex. S-3 at 4:20-23.

26 ⁵ Ex. S-3 at 4:20-23.

27 ⁶ Ex. S-4 at 6-7.

28 ⁷ Tr. at 7:18-19 and 10:18-20.

⁸ Tr. at 10:18-23.

⁹ Tr. at 123:3-7.

¹⁰ Tr. at 69:8-18.

¹¹ Tr. at 65:7-9 and 68:2.

¹² Tr. at 72:14-73:6.

1 Company”) and all of the holders of shares of stock of the Company[.]”¹³ The Agreement goes on to
2 state in its “Dividend Policy,”

3 Unless prohibited by law, the Company shall declare and pay dividends with respect
4 to each of its fiscal years in an amount at least equal to the sum of (a) a percentage of
5 its earnings and profits (as determined for federal income tax purposes) that is the
6 same as the highest federal and Arizona income tax rate on ordinary income for
7 individuals and (b) a percentage of its net long-term capital gains and net gains from
8 the sale or exchange of assets, the gain from which are taxable under Code Section
9 1231, which is the same as the highest federal and Arizona income tax rate on such
10 gains for individuals. Such dividends shall be declared and paid before April 1 of the
11 following year.¹⁴

12 Pursuant to the agreement, the Company reimburses shareholder taxes at the highest percentage tax
13 rate regardless of what the individual income tax payer’s actual percentage rate is.¹⁵

14 Unlike a C Corporation, a Sub-Chapter “S” Corporation (“S Corporation”) does not pay taxes
15 at the corporate level.¹⁶ As Mr. Myhlhausen explains, “The income or loss of the Sub-chapter S
16 corporation is passed on to the shareholders with no income tax liability to the corporation.”¹⁷ On the
17 other hand, a C Corporation pays corporate income taxes and individual shareholders pay taxes on
18 any dividend income they receive from the corporation.¹⁸ Thus a C Corporation is said to have
19 “double taxation” and an S Corporation, like a partnership, limited liability company, or sole
20 proprietorship, is considered a “pass through” entity for income tax purposes.¹⁹

21 As noted in the Recommended Opinion and Order (“ROO”) in the Sunrise Water Co. Rate
22 Application in Docket No. W-02069A-08-0406, “Unlike the losses of an S corporation, the losses of
23 a C corporation cannot be used to offset income on a personal income tax return.”²⁰ Additionally,

24 ¹³ Ex. A-5.

25 ¹⁴ Ex. A-5.

26 ¹⁵ Tr. at 39:2-9.

27 ¹⁶ 26 U.S.C. § 1363(a); Ex. S-4 at 3:21; Tr. at 18:2-6; Tr. at 96:7-10; *see also* the Recommended Opinion and Order in
28 Docket No. W-02069A-08-0406 at 29:14-16 (citing 26 U.S.C. § 1363(a)).

¹⁷ Ex. S-4 at 3:21-23.

¹⁸ Tr. at 18:4-19:17.

¹⁹ Ex. S-4 at 3:20-25.

²⁰ at 30.

1 “The Commission has established a long-standing policy of denying recovery of income tax expenses
2 for pass-thru entities and apparently has varied from it, at least in recent years, only as an exception
3 made under unique circumstances or as an inadvertent error.”²¹ The Arizona Court of Appeals has
4 held that the Commission has the authority to disallow income tax expenses in revenue requirement
5 determinations.²² The Commission has consistently disallowed income tax expense from revenue
6 requirement in cases involving S Corporations and Limited Liability Companies.²³

7 In Sunrise, like in this case, the S Corporation utility is not a taxable entity and thus individual
8 shareholder income taxes should not be the burden of Farmers Water’s ratepayers. This is especially
9 true whereas here, the utility is asking to recover, from its utility customers, individual share holder
10 income tax liability on non-utility generated income.²⁴

11 Farmers Water argues that, although Farmers Water does not pay income taxes at the
12 corporate level, individual shareholder tax liability should be paid for by ratepayers because of the
13 agreement between Farmers Investment and its shareholders.²⁵ However, the agreement, which
14 includes the payment of dividends that equal the taxes on the earning and profits and capital gains of
15 Farmers Investment, was entered into by Farmers Investment and its shareholders; neither Farmers
16 Water nor its customers are parties to the agreement.²⁶ The end result is the Company is asking its
17 ratepayers to pay the income tax liability of non-regulated, non-utility income of Farmers Investment.

18 Mr. Bourassa analogizes the situation in this case to that of a subsidiary C Corporation utility
19 of a parent holding company whose tax return is consolidated with the parent.²⁷ However, an S
20 Corporation is not a taxable entity, whereas a C Corporation is. Farmers Investment and Farmers
21 Water elected to be S Corporations and have the ability to become C Corporations if they so chose.

23 ²¹ Sunrise Water Co. Recommended Opinion and Order (“ROO”) in Docket No. W-02069A-08-0406.

24 ²² *Consolidated Water Utilities, Ltd. v. Ariz. Corp. Comm’n*, 178 Ariz. 478, 484 (Ariz. App. Div. 1, 1993).

25 ²³ See Fishers Landing Water and Sewer Works LLC (Docket No. WS-04047A-07-0700 and WS-04047A-07-0708)
(disallowing recovery of income tax expense); Winchester Water Company LLC (Docket No. W-04081A-07-0466)
(disallowing recovery of income tax expenses); see also Decision No. 60105 (S-Corporation allowed to recovery income
26 tax expense because Company was unable to obtain bank loan unless Commission approved rates allowed for income
taxes).

27 ²⁴ Tr. at 119-121.

²⁵ Ex. A-2 at 9-10.

28 ²⁶ Tr. at 119-121.

²⁷ Ex. A-2 at 10:8-13.

1 The Commission should continue to follow its established and long-standing policy of not allowing
2 utilities to recover individual shareholder income tax expenses from ratepayers.

3 **II. CUSTOMER DEPOSIT ACCOUNT INTEREST.**

4 Staff recommends that the Company be ordered to provide the standard six percent (6%)
5 customer deposit interest rate.²⁸ Staff makes this recommendation because, as Staff explained,
6 interest rates fluctuate and, although bank deposit interest rates may currently be close to two percent
7 (2%), in recent years interest rates were much higher.”²⁹ In fact, in 1999, the test year of the
8 Company’s last rate case, bank deposit interest rates were 9.5%.³⁰ The Company also has the ability
9 to seek recovery of customer deposit account interest expense in a future rate case.³¹ Furthermore,
10 the Company witness Ms. Triana stated that the Company does not collect deposits for new customer
11 hook-ups.³² Lastly, it has been approximately eight years since the Company’s last rate case, and it
12 may be another eight years before its next rate case. If the Commission adopts the Company’s
13 recommendation of 2%, the Company could be paying interest on deposits at a rate lower than market
14 rates for eight years or until its next rate case. Staff therefore recommends that the Commission
15 continue to order a six percent (6%) customer deposit interest rate as a reasonable average of a
16 historically fluctuating deposit interest rate.

17 **III. TWO- AND SIX-INCH STANDPIPE METER RATE DESIGN.**

18 Staff recommends no monthly minimum for two (2) inch and six (6) inch construction, bulk,
19 and standpipe customers and a commodity rate of \$2.45 per 1,000 gallons.³³ The higher commodity
20 rate of \$2.45 per 1,000 gallons (the highest tier commodity rate) is sufficient to cover the costs of
21 meter reading and administrative costs such as sending and collecting monthly bills.³⁴ Mr. Bourassa
22 suggested at the hearing that having a monthly minimum charge in addition to the meter deposit
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25 ²⁸ Ex. S-4 at 5:5-7.

26 ²⁹ Ex. S-4 at 5:5-7 and Tr. at 117:4-24.

27 ³⁰ Tr. at 117:11-16.

28 ³¹ Tr. at 68:12-15.

³² Tr. at 68:3-7.

³³ Ex. S-4 at 4:23-29 and 6-7; Tr. at 90:21-92:2.

³⁴ Ex. S-4 at 4:23-28 and Tr. at 111:3-16.

1 would further ensure that meters are returned by customers when no longer being used.³⁵ However,
2 as noted by Mr. Myhlhousen:

3 A monthly minimum charge [for standpipe users] is normally associated with
4 permanent customers and is designed to recover the fixed costs related to providing
5 such service. Any fixed costs that may be associated with providing standpipe service
6 are being recovered by the Company by applying the high commodity rate (third tier)
7 to all standpipe water sales.³⁶

8 That the Company is currently not requiring construction water users to pay a deposit for their
9 meters,³⁷ suggests that delays in returning meters is not a problem for Farmers Water. Additionally,
10 the Company did not claim to have difficulty retrieving construction water meters from its
11 construction water customers.³⁸ Therefore, the higher tier commodity charge for bulk, standpipe, and
12 construction water customers is sufficient to cover administrative and other costs associated with
13 meter reading and payment collection. Additionally, if the Company has problems in the future with
14 customers not returning meters, the Company can begin charging its authorized deposit for
15 construction, standpipe, and bulk water meters. Were the Commission to authorize the Company to
16 charge a monthly minimum charge for construction, standpipe, and bulk water customers, Staff
17 would not recommend the higher \$2.45 per 1,000 gallon commodity charge.

18 **IV. COMPANY WAGE AND SALARY EXPENSE.**

19 Although Staff initially recommended decreasing salary and wage expenses by \$14,589
20 (which Staff believed to represent bonuses) to \$165,919,³⁹ after clarification by the Company, Staff
21 later changed its recommendation to reflect the Company's proposed level of \$180,508 for salaries
22 and wages.⁴⁰ Staff and the Company now agree to a salaries and wages expense of \$180,508.⁴¹

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³⁵ Tr. at 49:16-50:2.

26 ³⁶ Ex. S-4 at 4:23-28

27 ³⁷ Tr. at 74:7-9

28 ³⁸ Tr. at 74:19-75:1.

³⁹ Ex. S-3 at 5:12-25.

⁴⁰ Ex. S-4 at 3:7-10; Ex. A-4 at 4:5-9; and Ex. A-2 at 6-7.

⁴¹ Ex. A-4 at 4:8-9.

1 **V. WATER LOSS.**

2 The Company is not opposed to Staff's recommendation that the company monitor water loss
3 through December 31, 2009, and submit a report by June, 2010.⁴² Both the Continental and Sahuarita
4 Highlands water systems showed water loss higher than 10%.⁴³ Although, the Company has
5 explained that the Sahuarita Highlands' apparent water loss of 32.2% may not be accurate due to the
6 filling of a new storage tank,⁴⁴ Staff maintains its standard recommendation regarding water loss:

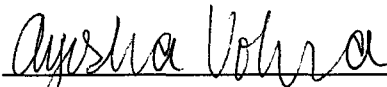
7 Staff recommends that the Company evaluate its water systems and prepare a report
8 for corrective measures demonstrating how the Company will reduce its water loss to
9 less than 10 percent. Water loss shall be reduced to less than 10 percent by December
10 31, 2010. If the Company finds that reduction of water loss to less than 10 percent is
11 not cost-effective, the Company shall submit a detailed cost analysis and explanation
12 demonstrating why water loss reduction to less than 10 percent is not cost effective.

13 The Company shall file such report with Docket Control as a compliance item in this
14 docket by June 30, 2010.⁴⁵

15 **VI. CONCLUSION.**

16 For the forgoing reasons, Staff respectfully requests the Commission to adopt its
17 recommendations in this rate application.

18 RESPECTFULLY SUBMITTED this 11th day of December, 2009.

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21 

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27 ⁴² Tr. at 68:19-25 and 69:1-4.

⁴³ Ex. S-1 at Exhibit JWL at 4.

28 ⁴⁴ Ex. A-6; Ex. S-1 at Exhibit JWL at 4; Tr. at 75-77 and 80-81.

⁴⁵ Ex. S-1 at Exhibit JWL at 4.

1 Original and thirteen (13) copies
2 of the foregoing were filed this
3 11th day of December, 2009 with:

4 Docket Control
5 Arizona Corporation Commission
6 1200 West Washington Street
7 Phoenix, Arizona 85007

8 Copies of the foregoing were mailed
9 this 11th day of December, 2009 to:

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